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Joel Dean

CAUSES AND CONSEQUENCES OF GROWTH BY CONGLOMERATE MERGER: AN INTRODUCTION

JOEL DEAN*

A worm's-eye view of conglomerates in action may be useful as background for the olympian discussions of public policy and antitrust law which grace this volume.

Conglomerate could be defined as any company that operates in several different and unrelated markets; GE and GM would meet this test. I use conglomerate here to refer to a company which in the 1960's has routinely acquired a large number of companies which operate in different markets. Thus the hallmarks of the companies I am discussing are (1) that they have grown importantly through acquisitions and (2) that their operating divisions are diverse and numerous.

Four anthropological questions about causes and consequences of conglomerate mergers are examined in this introductory essay:

I. What caused the population explosion of conglomerates?
II. What traits makes a company a tempting take-over candidate for a conglomerate?
III. What are the chief sources of potential economic superiority of the conglomerate?
IV. What are the main economic deficiencies of a conglomerate?

I. CAUSES OF POPULATION EXPLOSION OF CONGLOMERATES

We have had three major business merger episodes in the last century: 1875 to 1902, peaking in 1899; 1924 to 1930, peaking in 1929; and 1965 to date (which probably peaked in 1969). What explains the recent burst of activity in the formation and growth of conglomerates? It is too early to tell. The 10 explanations suggested in this section are put forward with trepidation. They may turn out to be more entertaining than valid. They are of three kinds: (A) those that can be laid at the doors of the Government (1-3); (B) those attributable to conditions in the securities market (4-8); and (C) those deriving from new techniques (9-10).

1. *Antitrust Suits*

The success of the antitrust agencies before the Supreme Court leads many executives to believe that courts have barred the way to horizontal,

* A.B., Pomona College, 1927; M.B.A., Harvard University, 1929; Ph.D., University of Chicago, 1936. Professor of Business Economics, Columbia University Graduate School of Business and Graduate Faculty of Political Science 1944-1969 (Emeritus Professor since 1969). President, Joel Dean Associates, 1940 to date.

vertical, and substitute mergers by large companies, thereby making conglomerates the only feasible avenue of merger growth. Horizontal acquisitions, no matter how small the overlap, look hopeless (*United States v. Von's Grocery Co.*[1]). Vertical acquisitions, after *Brown Shoe Co. v. United States*[2] appear unpromising. And after *FTC v. Procter & Gamble Co.*[3] (Clorox), even acquisitions of products related only by common distribution and by potential entry might be challenged. Hence growth by merger was driven into conglomerates by the courts (or perhaps by executives' misconstruction of court decisions).

2. Taxes

The tax laws have supplied an incentive to merge. By making possible "tax free" mergers,[4] by causing difficult estate-tax liquidity problems for the owners of hard-to-market stock, by creating an impellingly superior estate tax situation should one sell out to a conglomerate when his estate was mostly in the form of closely held, nonmarketable stock, mainly the tax laws created willing sellers.

3. Easy Credit

Expansion of money supply at a pace faster than the real economic growth of the economy, coupled with general ease of credit to the financial community and low interest rates, enabled companies with slender resources to take over huge corporations. Vast supplies of cheap credit accessible to merger promoters made available the financial resources needed in the short run for buying the stock and for financing the tender offer.

4. Magnificent Market

The size, perfection, impersonality and anonymity of our securities markets permit speedy and secret acquisition of a discomfittingly large proportion of the previously dispersed ownership of a candidate company.

Buoyant prices of conglomerate stocks, which facilitated acquisitions in the late 1960's, have now declined enough to create a barrier to further merger growth. Table I (on page 17), which shows acquisitions of nine conglomerates, indicates their stock price declines.

5. Investment Performance

A new concept and measurement of the portfolio manager's "investment performance" has helped to supply a favorable environment for conglomerates. The concept of owner welfare is correct: true discounted cash flow

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1 384 U.S. 270 (1966).
2 370 U.S. 294 (1962).
3 358 F.2d 74 (6th Cir. 1966).
4 Favorable tax rulings deferred capital gains taxation from the date of merger to the date of sale of stock (or of death), thereby conferring the coveted "tax free" label and removing a minor economic and major psychological barrier to merger.

TABLE I
ACQUISITIONS & STOCK PRICES OF CONGLOMERATES

	Number of Acquisitions 1958-68	Stock Prices 1968-69 High	3/20/70	Percent Decline
LTV	21	$136	$21	85%
Litton	77	104	26	75
Gulf & Western	87	66	17	74
Whittaker	38	94	12	87
Textron	51	58	23	60
TRW	25	60	34	43
Grace	42	53	22	58
ITT	44	62	52	16
Teledyne	78	45	23	50
Average				61%
Dow Jones Industrial Average		998	763	23
Standard & Poor Industrial Average		118	87	26

analysis (DCF) rate of return of dividends plus market appreciation, related to market value.[5] But to be significant as a yardstick of performance, the DCF return should, I think, both be adjusted for risk and averaged over a long period. Used short-term without risk allowance, it clothes speculation with professional respectability. How has it fostered conglomerates? In several devious ways: first, it supplies a warrant for a high multiple for a true "growth" stock (which all conglomerates aspire to be); second, it produced fabulous price rises of conglomerates, based on the belief that the steep short-term growth rate of earnings per share reported by their accounts was indefinitely projectable.[6] Understandably, rapid and uninterrupted growth in earnings per share is the central objective of the modern conglomerate. A third way is to impel the shift of portfolio management into banks and investment trusts and bring to the fore a new kind of performance-oriented professional portfolio manager.

6. *High-Multiple Myth*

Belief that a "growth company" could be created by an indefinite succession of conglomerate mergers produced a Wall Street wonder based partly

5 Capital appreciation (positive or negative, realized or not) must be included in the measure of investment performance. And capital appreciation (or decline) must be based on changes in the market value of assets. To use cost or book value for valuation in measuring and comparing investment performance is clearly absurd. But it is still widely used for pension funds and even defended on the grounds that because they do not need much liquidity they often invest in assets for which markets are imperfect and thin. A thin market makes it harder to estimate current market prices but does not reduce the need. These valuation difficulties can be overcome by methods and standards that I discuss in *Measuring the Investment Performance of Pension Funds*, Bank Administration Institute, Park Ridge, 1968, at 44-69, 183-188.

6 From 1963 to 1968 the average price of four established conglomerates (Litton, Textron, LTV and ITT) rose from an index of 100 in 1963 to over 450 at the end of 1968.

on the mystique of the unlimited versatility of "free-form" management. For a few crucial years, the market environment perpetuated the high multiplier of the conglomerate-acquirer (*e.g.*, Litton, Gulf and Western) and made each acquisition fuel for another.

The high-multiple myth is the belief that a company whose stock sells at a high earnings-multiple, because its gradient of growth in earnings per share has been steady and steep, can keep its multiple high and its price kiting indefinitely by a succession of slow-growth acquisitions by trading its own high-multiple (*e.g.*, 40 times earnings) stock (usually via convertible preferred) for the low-multiple stock (*e.g.*, 10 times earnings) of the pedestrian growth companies it buys. This myth has powered the formation and growth of many conglomerates.

7. Institutional Ownership

Institutional ownership of the stock of a target company makes that stock particularly susceptible to the blandishments of a conglomerate. How? Ownership is knowable, the block is big, and the tender offer (or private deal) gives the money manager the quick, measurable "investment performance" (mostly appreciation in the market price of the security) that he lives by.

8. Investopoids

The emergence of a new breed, investopoids (professional investors of (another's) money) has abetted conglomeration. How? The changed criterion of portfolio manager competence (DCF performance), plus the dramatically increased proportion of ownership of stock of American corporations by portfolio managing institutions (mutual funds, pension trusts, *etc.*) that are run by this new breed of investopoids, make increasingly large proportions of the stock of industrial companies highly susceptible to the typical conglomerate tender offer. The tender produces instant "performance." Moreover, ownership of the stock is more concentrated, more visible and more accessible to the new professional tender chasers.

9. Management Sciences

The new technology of the management sciences: mathematical models, statistical costing, probability surfaces, scientific sampling, computer simulation, profit center decentralization, *etc.*, has fostered conglomerates by promoting belief in the mystique of modern professional management's ability to manage anything equally well and to extend its span of control indefinitely with a new management technology. For example, profit center decentralization, a technological advance of the new science of managerial economics, has fostered conglomerates by making plausible two inconsistent aspirations: continuation of complete independence of the old management of the acquired company and strong modern central controls by a "professional" top-management of the conglomerate. A quarter century of mostly successful experience with profit centers reveals limitations which are particularly serious for the diverse divisions of a modern conglomerate, and which will be examined later.

10. Advanced Acquisition Technology

Advances in the technology of acquisitions are a contributory cause to the recent wave of conglomerate mergers. Techniques of the tender offer have been improved and refined. They are supplemented by the ministrations of a new profession: the stockholder relations politician who, for a fee, will peddle the tender and get out the vote.

A key concept for keeping the conglomerate's stock rising and its stockholders permissive about acquisitions is to manage reported earnings so as to produce a steep and steady growth in earnings per share. The acquisition process itself could in the late 1960's achieve this. First, an increment in per share earnings usually resulted from the share exchange rates; *e.g.*, if a conglomerate priced at 40 times earnings could trade its stock for an acquired company whose earnings multiple was 10, its per share earnings were thereby stepped up. Second, earnings of the acquired company were frequently stepped up at least temporarily; sometimes assistance (or milking) increased its profit margin; sometimes (accidentally or by design) an acquisition occurred in the midst of a cyclical upswing. The resulting growth in earnings was usually projected as a trend. It was steeper than the acquired company's true historical trend would suggest. Third, some (possibly temporary) improvement in earnings resulted from better financial controls, synergism or just sheer shake-up.

The amount of projectable growth in earnings per share that resulted from these three phases of the acquisition process was often masked by accounting practices designed to conceal internal growth of earnings and to prevent discrimination between ephemeral and persistent growth. In the euphoria of those times, there was a widespread belief that the source of growth in earnings per share did not matter for its projectability so long as that growth was rapid and uninterrupted. Consequently, during 1967 and much of 1968, the high multiple of the acquirer (rather than some average of 40 and 10) tended to continue for the composite, based on faith in the projectability of "managed earnings."

The advanced technology of "managed earnings" called for sophisticated and creative use of the wide zone of bookkeeping discretion in reporting assets, reserves, and earnings of acquisitions. Thus imaginative exploitation of highly permissive accountancy has been an important part of acquisition technology.

Dilution is an important aspect of the fuzziness of reporting techniques of acquisition companies. Since about 1967, some of the dilution impact had to be revealed. Gulf & Western stockholders found out during 1968 that earnings for fiscal 1967 were $2.84, not $3.69 as earlier reported. From this new benchmark, 1968 earnings of $3.14 showed a gain. (*Fully* diluted 1968 was really lower than that by about 16 percent.)

Another aspect is the widespread use of pooling of interests in mergers. This device enables an acquiring company to ignore for bookkeeping purposes the excess of the acquisition price (*e.g.*, $5 million in stock) over the book value of its measurable assets (*e.g.*, $3 million) by simply combining the books of the two companies. These intangible assets (which are valued in terms of the merger in our illustration at $2 million) although purchased (with stock), never appear on the books of the conglomerate.

The Accounting Principles Board of The American Institute of Certified Public Accountants recently proposed that the surviving corporation be required to write off against earnings (over a period as long as 40 years) the intangible assets acquired by merger. Such amortization will pull down the earnings per share reported into the future and dampen enthusiasm for some mergers.[7]

The intangible investment acquired by merger is neither less valuable nor more depreciable than that which is home grown. So the reduction in reported earnings resulting from this rule will not make them either more accurate than or more comparable with the pre-merged situation, or less subject to manipulation — only littler.

II. Traits that Tempt Take-Over

What characteristics make a company a tempting target for conglomerate take-over?[8] Eight traits strike me as significant.

1. Bad Management

Incompetent management makes a company an easier take-over target because unhappy stockholders are more susceptible. Incompetence in resisting take-over is different from, and generally, although not necessarily, correlated with efficiency in maximizing the welfare of the common stockholder. Superb management being scarce, there is no shortage of companies that meet this requisite.

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7 A recent study of 26 NYSE companies that have been active acquirers showed that in 169 "poolings of interest," the difference between book value and purchase price averaged almost two and a half times the book value. The impact upon reported earnings of writing off these purchase intangible assets depends, of course, on the speed of write-off. With five year write-off, the effect of pooling for 6 of these concerns was "to overstate" 1967 earnings — hypothetically, at least — by 50 percent or more, the study concluded. The study, made by Professors Ronald M. Copeland and Joseph F. Wojdak of Pennsylvania State University, was reported in the Wall Street Journal, February 27, 1970.

The SEC has required inclusion for prior years of companies that are acquired on a pooling-of-interest basis in registration statements and in annual reports for at least the preceding year. But the realities of internal growth of earnings could still be hidden because purchases could be excluded.

8 Most companies who sell out are willing. Why? Estate, health, or successorship problems; resource or know-how limitations on opportunity or a price he could not resist. Why sell to this particular conglomerate? Generally because it best meets the seller's particular needs for operational independence, congenial bosses, latest managerial technology, marketability, and a good investment at the merger price.

2. Willing Management

Willing or peace-loving management has made many companies tempting targets. Inadequate estate diversification and insufficient liquidity to pay estate taxes sometimes catapults smaller firms into the arms of conglomerates. Aged and successorless management sometimes sees rescue there.

3. Excessive Liquidity

Cash-plethora has been a tempting take-over trait, particularly in the early post-war years, when conglomerates were able to buy a company with its own cash.

4. Unused Borrowing Power

An almost pathological aversion for debt on the part of industrial companies has produced capital structures so bereft of leverage that a conglomerate could buy a company with its own excess and unused borrowing power.

5. Excessive and Unproductive Plowback

Niggardly dividends tempt take-over by a tender which tops the payout with a convertible preferred. Poor visibility of the prospective capital gains that result from high plowback means that sometimes a company can be bought for its own (capitalized) plowback. A company that invests its cash-flow plowback unproductively is a tempting take-over target. Below-par productivity of capital is signalled by acceptance of capital projects which have prospective DCF rates of return that are lower than the company's composite cost of equity and debt capital. Why does this make the company tempting? Because it shows opportunities for profitable asset deployment by internal channeling of investable cash that is generated by operations of the take-over target company into other parts of the conglomerate where opportunities are richer.

6. Huge Depreciation

Big book write-offs (depreciation and depletion) tempt take-over because modest and disappointing reported book earnings can be accompanied by big cash earnings relative to dividend payout. The result is that a company can sometimes be bought with its own future stream of corporate savings.[9]

7. Cash-flow Imbalance

Two kinds of imbalance of cash-flow render a company attractive. One is cash generation that greatly and continuously transcends the company's internal investment opportunities. This condition is indicated by a pile up of cash or by low-return investments. A second kind is the converse: op-

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9 Jones & Laughlin Steel Company, for example, had cash earnings which in the three years, 1965, 1966 and 1967, aggregated more than $350 million. The market price of its common stock in the second half of 1966 was a little less than $350 million.

portunities for profitable investment that greatly exceed the company's cash generation. Combining the two kinds of companies is an important economic mission of conglomerates.

Most companies are in balance (forced or natural). A high proportion of the $100 billion of business investment comes from cash-flow that is generated by operations and is rationed within corporate boundaries. Hence, cash flow imbalance of either kind can make a company a logical take-over.

8. Unusable Tax Shields

The start of many a conglomerate was a merger with a tax-loss carry-forward. The company was bought with its own potential income tax reducing power. More recently, it is future losses which can reduce the taxes of acquired companies that makes big losers good bedfellows in the conglomerates. More complete and efficient use of tax shields — past, present and prospective — has been an incentive to acquire; and stockholders benefit from such mergers.[10]

III. Sources of Superior Economic Performance

Although conglomerates have been buried under an avalanche of condemnation, they do have sources of superior economic performance. Whether these potential economic benefits will become actualities in any particular conglomerate is uncertain. Whether they will result in *net* gain from conglomeration depends on the importance of offsetting drawbacks, examined in the next section.

The basis of potential superiorities of a conglomerate is comparison with its constituent companies, *i.e.*, what would have happened absent conglomeration compared with what will happen with it.

The concept of economic performance here is a narrow one, limited to private costs measured ultimately by long-run profitability and generally indicated by competitive success. "Social costs" and impacts on the functioning of the national economy are beyond the scope of this analysis.

There are 10 potential sources of superior economic performance:

1. Better rationing of capital.
2. Better mobilization of internally-sourced capital.
3. Lower cost of capital.
4. Better allocation of human resources.
5. Better successorship.
6. Full utilization of tax shields.

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[10] Buying a tax loss carryforward is understandable, but would a conglomerate buy future losses on purpose? Potential *tax* losses, yes: example, a railroad that can rip up redundant tracks and thereby establish tax losses in the future. Another source of tax benefit from merger is fuller use of tax shields. When the amount of the potential tax shield (*e.g.*, depletion or investment tax credit) that could be taken for tax purposes will be limited by the amount of a company's profits, this limitation can sometimes be removed (or reduced) by merger with a company that will have a plethora of profit.

7. Greater managerial accountability.
8. Better financial controls.
9. Greater cross-industry mobility.
10. Scale economies of staff services.

1. Better Rationing of Capital

Corporate funds of a conglomerate can be deployed across former corporate borders to those divisions where they will earn most. Funds can be rationed more knowledgeably and efficiently within the corporate fold than across corporate boundaries by the cumbersome, costly, and relatively ignorant allocation of funds by the impersonal capital markets, where leakages of personal income taxes on dividends additionally deter movement and add to its apparent cost. Who has seen in a prospectus *any* information about the specific capital projects in which the money will be invested? In contrast, inside a conglomerate, proposed investments (intangible as well as tangible, expensed as well as capitalized) can be made to compete for a common pool of corporate funds on the basis of prospective return on that investment. Moreover, the imposition of a minimum acceptable return which is based on the composite cost of capital to that corporation is more explicit and more likely than if rationed by the capital markets. Acquisitions of additional companies (being a way of life for a conglomerate) should and can compete with internal investments for funds. This should include buying in the conglomerate's own stock when no internal or external investment promises a higher yield.

Thus, expanded investment opportunities, intensified competition for funds, and a clearcut criterion of their cost, can remove (or lessen) the temptation which is present in some companies to prefer a low return investment to paying out highly taxed dividends.

2. Better Mobilization of Internally-sourced Capital

The supply of capital for corporate investment comes ultimately from savings: of individuals, of corporations, and of governments. The corporation can itself save or can tap the savings of others. The main internal source of funds, corporate savings, is the gross cash earnings generated by operations, which constitute a common pool of future funds from which dividends will be paid and new investments financed. In a conglomerate, this pool should have corporate-wide availability for capital expenditures. To restrict each division to the reinvestment of its own cash earnings (depreciation charges, plus earnings), regardless of the productivity of its proposed investment, would destroy a major source of economic superiority of the conglomerate.

Another internal source of capital that is potentially better mobilizable in a conglomerate is disposal of assets. Assets (*e.g.*, plants, ventures, divisions) should be sold if forecast to produce a rate of return on their disposal value which would be lower than the corporation's combined cost of capital. Such disposals ought to be a more important source of capital for the conglomerate because the opportunities, the propensities and the incentives to redeploy its capital are greater.

Capital sources for this internal deployment of investment should (and do) include divestiture (liquidation, spin-off or sale of majority control of an operating unit). Divestment (and other asset disposal) is likely to be more feasible and less unpalatable than for the acquired company, because of the conglomerate management's lack of emotional attachment.[11]

3. *Lower Cost of Capital*

Over the long run, conglomerates will probably have a lower composite cost of capital than their constituent companies would have had. This is mainly because of deeper debt, since the after-tax cost of conglomerates' convertible preferred (which may ultimately be replaced by debt) is high. It is reasonable to expect the price of common stock capital to be lower for a big company, but there is little empirical evidence to support this belief. Because of market disaffection, equity capital is currently more costly for a conglomerate than for a less diversified corporation of the same size. The cost of debt capital to a conglomerate, however, is likely to be somewhat lower than for its constituent companies.

The composite cost of capital is more affected by capital structure than by differences among companies in the price of equity or the price of debt. The after-tax cost of debt capital, even at today's 10 percent interest rates, is much lower than that of equity capital. Depth of debt is determined more by management's willingness to borrow than by its ability. The result is that most industrial corporations have a composite cost of capital significantly higher than would be attainable with deeper debt. Conglomerates may (because they are bigger and more diversified) be *able* to borrow deeper. But more importantly, they will probably be *willing* to borrow deeper for two reasons: first, because leverage has been heavily used by the management in putting the empire together; and, second, because preferred stock (not being tax deductible) impels subsequent replacement with debt.

4. *Better Allocation of Human Resources*

An important economy of corporate size is the ability to appraise the performance and potentialities of executives so as to move and promote them to where they will do the most good. It is important because the

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11 During the period 1958 to 1968 Textron had ten divestitures, a fifth of the number of acquisitions (51); LTV divested 9 units of its 21 acquisitions.

Conglomerates have recently used unconventional and imaginative methods of divestiture. Open and widely publicized invitations to bid for a unit that a conglomerate wants to sell off recently upset the conventional wisdom of secrecy and playing hard to get. Northwest Industries is entertaining a proposal by senior executives of the Chicago and Northwestern Railway that the road's 14,000 employees acquire this unit of the conglomerate. (Wall Street Journal, March 20, 1970).

marketplace, despite the important contributions of stock options to executive mobility, and despite the rapid growth and prodigious accomplishments of "executive-search" professionals, does not allocate executive resources perceptively and efficiently across corporate boundaries. Quite understandably, corporations try to hide and hang on to their best. And this happens also within a conglomerate, but to a lesser degree.

The gains from a more perfect intra-company market for talent are reduced by the heterogeneity of management problems in a conglomerate. Nevertheless, it has the potential of allocating its human resources better than its unaffiliated constituent companies. Finally, conglomerates tend to be more willing and more experienced in going outside for talent than most companies, who tend to be a bit provincial about home grown executives.

5. Better Successorship

Failure to develop or find successors for top management has been an important motive for selling out to a conglomerate. Implicit is a mutual belief that the management of a large diversified company will be able to find within its family or raid talent from outside and thus develop successor management — better at least than that constituent company which has in this failed.

Successorship may turn out, in the long run, to be a crucial deficiency of the conglomerate. This depends on (1) whether the popular doctrine that modern professional management (like Lord Jim) has ability in the abstract which is highly transferable across industry lines proves fallacious, (2) whether the limitations on profit center decentralization in conglomerates can be overcome, and (3) whether a synthetic substitute for sharply focused ownership motivation (*e.g.*, stock options in partial spin-offs) can be developed. Consequently, assured successorship as a potential source of superiority is uncertain and perhaps, at best, marginal.[12]

6. Fuller Utilization of Tax Shields

Bundling diverse corporations under a single tax return increases the probability that tax losses will be fully utilized. It thereby steps up after-tax profits — a widely accepted index of economic performance (whether or not tax minimization of this sort is viewed as a social good).

7. Greater Managerial Accountability

Better measurement of management performance at the level of the division (constituent company) and more accountability is a potential and probable consequence of joining a conglomerate. Chances are that before joining, neither the stockholders nor the directors have held a tight reign on

12 When a successful firm is taken over by a conglomerate, it is usual for some of its executives to quit. The scope and status of some will shrink and all face an altered bureaucratic environment. Because the dream of running his own show is dead, presidential aspirants can be early casualties of the take-over.

the president. In a public (*i.e.*, dispersed ownership) company, directors tend to be too eminent, too busy, too ignorant and too nice to ride the president hard. Stockholders, even big institutional ones, nowadays sell the stock rather than try to throw out or even castigate the management. In contrast, when a company is taken over by a conglomerate, its management becomes accountable, not to an invisible stockholder electorate or a benign board, but to a professional "high command" which is likely to be geared to greed, and able to have sophisticated economic mechanics of profit center decentralization and measurement of management performance.

8. Better Financial Controls

Applications of managerial economics to operating financial management have advanced rapidly in recent years. Its principles and even its procedures are more versatile and transferable than any other aspect of modern management except portfolio investments, insurance and tax management.[13] Some conglomerates (*e.g.*, Litton, Grace, I.T.T.) have assiduously mastered advanced techniques of operating financial management. In sharp contrast, many corporations that were taken over have been woefully deficient in modern financial analysis and controls. Closing this cultural lag has been a source of superior economic performance that may continue to be important.[14]

9. Greater Cross-industry Investment Mobility

Conglomerates probably have somewhat greater capability of getting into industries which have above average potential growth and profitability than have their constituent companies were they unaffiliated. The concept of a conglomerate should, I think, be an institutionalized technique for forced migration of investment under close managerial control, moving from mature, profit generating industries which have passed their zenith of growth, into new high-profit growth industries which (as in the human family) must be initially subsidized by those of earning age. Guided by this concept, a conglomerate will be more alert to foreseeable, underbuilt, growth opportunities than would its unaffiliated constituents and more likely to do something about it.[15] In this mission, conglomerates have, however, a serious

[13] The capability of the computer to implement the simulation models, decision rules, and DCF analysis of managerial economics makes it possible for technicians in the new management sciences to make contributions to financial planning and control, even though they are handicapped by lack of operating experience in the conglomerate's diversified businesses.

[14] The market once valued conglomerate stocks as though the growth in earnings per share from this source would continue indefinitely. This gain is not projectable unless acquisitions that are equally benighted continue at the same percentage rate indefinitely. Moreover, there is little reason to suppose that growth of earnings from these infusions of modern managerial economics will be faster than that of pre-existing companies which already use advanced techniques of management science.

[15] One mission of the conglomerate is to penetrate these new growth areas that the investor, even if he recognized the promise, would not be able to exploit absent the vehicle of the conglomerate. A second is to exploit a market-tested technical breakthrough

constraint: a merger must not only be desirable but above all "doable," *i.e.*, priced right and attainable by seduction or force.

10. Scale Economies of Staff Services

The savings of size obtained by conglomerates are not those of larger scale manufacturing at the plant level. In most industries these scale economies peter out at a relatively modest size. In any event they are usually attainable by constituent firms without benefit of conglomeration. Anyhow, if they are important, they would be achieved by horizontal rather than conglomerate merger. The important scale economies of a conglomerate, if there be any, are at the level of corporate staff services: research and development, computers, programming, national advertising, financial staff services, captial sourcing, etc. They are hard to measure and easy to overestimate. Most of these services can be obtained at the marketplace by small-scale users at costs that are competitive with large-scale self-supply. Even big companies hire Battel to do research, use time-shared computers, buy software from outsiders, partner with strangers on national television, and hire economic and financial consultants. The "make-or-buy" choice is ever present and often close.

IV. Sources of Inferior Economic Performance

Offsetting these potential sources of superior economic performance are some important deficiencies in the economic efficiency of conglomerates. Several kinds are examined in this section. The benchmark for these sources of inferior economic performance is what would have happened had the constituent company continued unaffiliated. The yardstick of economic efficiency is earnings after-tax, ideally economic profits in real terms stripped of monopoly gains. Deficiencies of eight kinds strike me as important:

1. Distortion of corporate goals.
2. Non-economic product mix.
3. Limited cross-industry transferability of managerial ability.
4. Imperfect profit center decentralization.
5. Excessive size.
6. Excessive preoccupation with growth.
7. Top-heavy capital structure.
8. Impaired managerial incentives.

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more massively and more efficiently than the acquired company — more massively by access to internal employment of sources within a conglomerate and sometimes by removing a capability-ceiling of internal growth. A man who has built up his own business to a size equal to his personal capability, can sometimes, by using the professional staff services of the conglomerate, get the capacity to profitably grow bigger. This presumes, of course, that the founder will stay on the job and that the conglomerate will be able to develop successors.

1. Distortion of Corporate Goals

Building a bigger empire appears from behavior to be the central goal of some conglomerates. Perhaps we are entering a new era of financial capitalism which will displace industrial capitalism. Possibly sheer size, and the accompanying personal power of the financiers who create conglomerates, will transcend the long-run welfare of the common stockholders as the overriding goal of the conglomerate corporation. If this happens, it is bound to impair the economic efficiency of the conglomerate and its constituent companies.

Some economic theorists, relying on executive interviews and company public statements, as evidence, say that growth has already quite generally achieved a new and independent status as a corporate goal.[16]

Maximization of long-run profits, *i.e.*, maximizing the present worth, at the corporation's cost of capital, of the per share dividends, and capital appreciation, after taxes, should be, I think, and quite commonly is, the overriding corporate goal.[17] Any firm that does not have an impregnable monopoly position had better concentrate on this objective if it does not want to be shoved aside by those who do. Pursuit of stockholder welfare leaves the company free to choose among strategies for attaining it but makes subsidiary to it objectives such as maintaining market share, stability of employment, and attaining any given rate of growth. Management and stockholders should have no preference between growth and shrinkage in size of firm, except as they may influence the present worth per share of future stockholder benefits.

Significant departure from this overriding corporate goal on the part of top management of a conglomerate produces economic inefficiency because it substitutes an inferior criterion of optimization (*e.g.*, growth, size, capacity-share, and diversity) in the trade-offs of current operating decisions and in the rationing of capital for tangible and intangible investments.

2. Noneconomic Product Mix

The product lines of the typical conglomerate have been achieved accidentally. They are mostly the result of opportunity. The important trait of each acquisition was that it was "doable." Rarely do the diverse products and activities that result from opportunism actually support one another synergistically (as is often claimed). Rarely do the product lines have significant managerial similarities that obviate the need for managerial special-

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16 Acceptance of this as evidence is seen in Baumol, *On the Theory of Expansion of the Firm*, 52 AM. ECON. REV. 1078 (1962).

17 The president of a Japanese company took interesting exception to my doctrine: Japanese stockholders are essentially speculators, congenitally disloyal in-and-outers, whereas executives commit their whole lives to a Japanese company, continuing in its service from the day of college graduation until retirement. Consequently, he reasoned, the overriding corporate goal should be the welfare of the executives, not of the stockholders.

ization by industry and consequently produce *net* economization of management.

Today, few diversified companies admit to being conglomerates. Hence they seek and always find some plausible concept of similarity (recreation, household needs, communication, etc.) with which to rationalize away their diversity, which was, in reality, achieved mostly accidentally.[18]

3. Limited Cross-Industry Transferability of Managerial Ability

The diversity of the conglomerate's operations causes heterogeneity of top management problems. The inevitable lack of specialized industry experience makes the High Command unable to master the intricacies and ramifications of the highly diverse competitive situations and technologies of its diverse industries. The conglomerate's chief executive lacks the industry experience needed to make good intuitive judgments on the crucial imponderables. To justify acquiring companies in wildly diverse industries, a new doctrine, "free form management," has been promulgated. It asserts that a good manager can manage anything equally well, *i.e.*, that managerial ability, having achieved the status of a profession, has the generality of application which characterizes a profession, and is therefore fully transferable and equally efficient in any industry.

This is, I think, a fallacy. Except possibly for a few specialized, technical staff activities, managerial efficiency is usually tied quite closely to the particular industry or setting in which the manager develops and operates. The reason is that a good manager's intuitions grow out of long experience with the special markets, competitive structure, and technology of a particular industry. When a new ownership group must rebuild a management from outside, it raids rivals *within* the industry. "Executive-search" specialists discourage industry jumping. In successful large corporations, most executives at or above the division manager level have long service records. Of the 65 active executives whose portraits appeared in the 1962 annual report of General Motors, only 6 have less than 20 years service with General Motors. The 32 managers of domestic product divisions averaged 33 years.

The staff specialist exception, which is also supported by biography and by executive raiding, reinforces the rule. It is only in those areas of functional managerial specialization where there is a high degree of commonality despite diversity of industrial application that centralized staff work by spe-

18 For example, the president of Northern Illinois Gas Company, after stoutly declaring that the utility doesn't intend to become a conglomerate but would stick to connected activities which would have a direct bearing on the territory it serves, announced aspirations for his company to build moderate income housing, provide tracts of land for industrial development, mine recently discovered coal deposits, develop gas fueled waste disposal units, automatic meter reading devices, fuel cells, and devices to use compressed natural gas to power automobiles, and ultimately produce a protein for human consumption made from natural gas (Chicago Tribune, January 18, 1970). The unifying concept which removes the conglomerate curse from this variegated bundle of products is that they all have "a direct bearing on the territory" which the utility serves.

cialized professionals can be efficiently done for divisions with extreme diversity as to industry, competitive situation, and marketing mechanism. Examples include management of insurance, taxes, pensions, investment portfolios, personnel mechanics, accounting, computers and some aspects of management of money.

Generalized managerial ability exists primarily as a potentiality of the young. Actual management productivity derives from specialization in the technology and markets of a particular industry.

4. Imperfect Profit Center Decentralization

Profit center decentralization is an efficient means of delegating responsibility for maximizing short-run profits while retaining control of most of the investment decisions that affect profits in the long run. Experience over the past 25 years indicates, however, that profit center structuring of management has not eliminated but only somewhat reduced the managerial disadvantages of diversity and size. They are not eliminated because of limitations of profit center decentralization. Four are important.

The first is that delegation of responsibility to maximize even short-run profits is necessarily incomplete, due to imperfections of economic mechanics and to ingenuity in ways to beat the performance measurement.

The second is that intangible investments in future profits (*e.g.*, development of products, markets, and people) war with current short-run profits, by which the division manager's performance is dominantly measured. Yet these expensed investments in the future are intertwined with current operations and their future effects are so hard to forecast that they require a high order of experienced, specialized judgment. Consequently, profit center managers are peculiarly qualified to make, or at least recommend, such investments. Their performance in such futurities is much harder to calibrate than on current profits and conflicts with it. Example: research.

A third limitation of profit center decentralization is the difficulty of providing the profit center manager with motivation equivalent to ownership. This is needed to make his interest identical with the owners, so that his decisions and recommendations as to investments will conform to the overriding goal of the corporation, namely to maximize the long-run welfare of the common stockholder. Stock ownership or options in the mother company do not even approximate the narrow ownership incentives that are needed for his profit center.[19]

Fourth, the industrial diversity of a conglomerate makes delegation of responsibility for long-term profits more necessary — and more perilous. Delegation is both more needed and more dangerous because the High Command does not have enough intimate experience with each diverse industry

[19] Spin-off or public sale of *part* of the stock of a subsidiary can, by establishing a market price, make possible executive ownership and stock options that can supply division management with motivation for long-run profit maximization and provide a rough measure of the present worth of these anticipated future earnings.

to guide (or reverse) decisions of profit-center managers on intangible investments, where short-run profits must be sacrificed for long. Yet it is precisely these investment judgments which must be made correctly in order to get asset-redeployment benefits from conglomeration. Cash that is generated by losers must flow to winners. Reinvestment must be restrained in obsolescent or moribund activities (because productivity of capital is low) and their cash earnings deployed to activities where added investment has high return. If the divisions of a conglomerate can really be as independent of each other as the holdings of a mutual fund, they will perform better and be worth more if freed from the restraints and burdens of a nonproductive top management. If they are not this independent, then the "high command" has a function. And to perform this managerial function efficiently requires it to cope with diversity without adequate specialized experience, in the various industries under its control.

5. *Excessive Size*

Inefficient, nonmonopolistic concentration of wealth may be the chief sin of conglomerates. It may also be a competitive handicap. From the standpoint of efficiency in serving consumers (putting aside any social or political effects of "concentration") three dimensions of size should be distinguished: (1) size of the conglomerate as a whole, (2) size of its divisions (profit centers, companies), and (3) size of plants (or other activity unit).

What should be the criterion of optimum size? Classically it is minimum cost. But it could instead be (1) the optimum size for getting business (measured by changes in the market share of firms in different size classes) or (2) optimum size for making money (measured by changes in share of profits of "industry" for firms of different size classes or by comparison of rates of return on investment) or (3) optimum size for survival (measured ultimately by mortality rates or by changes in share of industry output produced by each size-class over time.)[20] This latter survivor technique measures also relative efficiency of firms (or plants) of different sizes in coping with all the problems that management actually faces.[21]

Profitability is, on the whole, the most relevant measure of economic efficiency in the highly competitive American economy.[22]

For conglomerates, a dramatic issue is the shape of the managerial cost

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20 There is considerable acceptance (and some empirical support) of the proposition that firms can be too small, but not too large, except in relation to the size of their market. It is not, in my judgment, correct. The enormous differences among industries in average size of firm cannot be explained by market size; this would require an incredibly discriminating and compulsive adaptation to this one environmental factor.

21 G. Stigler, The Organization of Industry 72-80 (1968).

22 A major task of conglomerate management is to find: (a) the firm's most profitable size, (b) the firm's most profitable array of activities (products), and (c) the optimum size of each activity. The three are interrelated and may change as the firm's size changes. Each optimum at each point in time will be influenced by technology (including advances in management science, computers and profit centers) market size, consumer preferences, and the conglomerate's tangible and intangible resources.

curve. At what size do the scale economies of central management of a diversified empire run out? Management is just another factor of production. Like other kinds of labor, managers find it efficient to specialize by function and by industry. Additional economies in the division of managerial labor within the firm provide an incentive to grow to the size that permits full use of an efficient managerial group. Beyond some point, the managerial cost curve turns upward, with the exhaustion of managerial economies of scale and the ever present rising costs of coordination. Larger firms exist but they owe their size to the continued pull of scale economies of some sort (or to lag in the marketplace correction of human error or to impregnable monopoly position). For every very large firm, that is not a sheltered monopoly, a plausible and important source of scale economies can be found that is entirely consistent with a rising managerial cost curve. If the management of General Motors is superb, it has found a way to shift to the right the rising curve of management cost, thus permitting a further exploitation of the enormous scale economies attainable in the integrated design, production, and marketing of motor driven vehicles and related products. The equal availability of superior managerial talent has not been enough to compensate for the *absence* of similar production scale economies in dozens of other industries. For most companies, justification for larger size must come from some scale advantage other than an alleged increase in the efficiency with which the enlarged company can use *managerial* resources.

After it attains some size, which is far below *Fortune's* 500, the conglomerate experiences rising costs of coordination and control. Where optimum size appears to be large, this is explained by great economies of scale in manufacturing, distribution, or research (or by an impregnable monopoly position) rather than by scale economies in management.

6. *Preoccupation with Growth*

The economic efficiency of some conglomerates is impaired by preoccupation with growth to the neglect of operating profitably. Growth by acquisition is a way of life. Growth has become an independent, even overriding, corporate goal. Instead, it should be subsidiary to long-run profit maximization. But in the current passion for "growth stocks," it is sometimes said that opportunity, creativity, and even profitability[23] all require growth and that the only alternative to growth is decay. This is a fallacy.

Growth does sometimes supply a special sort of intoxicating atmosphere in which employees may work longer or more effectively or for a smaller current salary and in which some suppliers give special attention or conces-

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[23] Growth does not cause profits. Firms should, and generally do, grow in order to take advantage of foreseen opportunities for unusual profits. Whether growth or profits come first depends on ability to forecast and react to profit prospects. Sometimes a prolonged experience of heightened profitability may be necessary before enough firms conclude that expansion will also be profitable. Hence, time lags between changes in profitability and changes in growth rate prove nothing about causation.

sions to customers they think will become large accounts. A growing firm sometimes finds it easier to bury mistakes. But it is easy to overstate the long-range benefits of growth. Stable firms can, by progressiveness, achieve much of the stimulating atmosphere of growth. Growth ought to be thought of as a way of attaining optimum size when the firm is smaller than optimum.

7. *Top-Heavy Capital Structure*

Some conglomerates are saddled with high quasi-fixed charges. To get the 80 percent ownership needed for a consolidated tax return, they swapped convertible preferred with dividends considerably above those of the common stock it replaced. How can this increase in payout impair efficiency? In two ways: first, the company's credit may suffer, its ability to finance cheaply impaired more by passing a preferred dividend than by reducing or omitting dividends on the common stock; second, the company pays more taxes than if the senior securities were instead debentures. This is the price of a "tax-free merger."

8. *Impaired Managerial Incentives*

Ownership is the cheapest incentive known to man. And the lively anticipation of ownership runs a close second. We have not been clever enough to develop an intra-conglomerate synthetic which gives the manager of a constituent company incentives that are as powerful and that parallel as closely the long run interests of the common stockholder as did substantial ownership (or stock options) before the merger. Consequently, the executives who built the constituent companies, even when they do continue, are often not quite the same men.

The heady responsibility, power and (sometimes illusory) freedom of "running my own show" as president of an unaffiliated company attracts and holds an entrepreneurial type of man which a big business bureaucracy is not good at developing or holding. Although this kind of executive is needed in our dynamic enterprise economy and is particularly needed by the operating units of conglomerates, nevertheless the required incentives and independence generally cannot be provided by conglomerates. So when a successful private firm is taken over, some of the more enterprising souls leave — in spirit if not in body. Also, it is distressingly common for some of the older employees to see in the conglomerate's sharpened attention to profitability, an abandonment of the firm's traditional interest in making a better product than its competitors. Morale sometimes suffers because many employees are less inspired by a goal of higher profits than by a goal of a better product (even though it will ultimately lead to higher profits). Impairment of morale from this source may be more a result of poor communication or poor translation of a profit objective into subsidiary goals than a result of a different overriding goal.[24]

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[24] But sometimes take-over brings a change in master goal: for example, when

Management will, I think, prove to be the crucial deficiency of the conglomerate. Two spots are critical: (1) Top talent, which is scarce and hard to reproduce, and (2) Division managers. Rare gifts are required at the top to run a diversified company well. Hence its fortunes are peculiarly sensitive to the competence, stamina and motivation of one or two men at the top. Can ITT find, groom and select for succession another Harold Geneen? Can Litton develop equally gifted successors for Thornton and Ash? The other critical spot is heads of the operating divisions who feel downgraded and neglected. Isolated and restrained by intervening echelons and by specialized staff, division managers find that bureaucratic, rather than entrepreneurial, traits have survival value. Criteria of optimization are distorted toward maximizing the manager's score in this new ball game.

V. Transition

The purpose of this concluding note is to ease the transition from the low plane of the preceding essay to the loftier level which is to come. Economic performance, in my analysis, is confined to that reflected by private costs and roughly measured by competitive success and ultimately by profitability. Hence the measuring rod of efficiency is after-tax earnings in the long run (ideally in constant dollars and stripped of monopoly profits). Social costs that are not reflected in private costs are not considered; and broader consequences for the economy as a whole are neglected. The viewpoint is essentially that of the non-peripatetic stockholder.

Looking at conglomerate mergers more broadly in terms of their contribution to the functioning of a private enterprise economy raises different questions concerning their economic effects. Does conglomeration cause:

1. Quicker responsiveness to changed desires of consumers?
2. Prompter commercialization of scientific advances?
3. Better allocation of resources?
4. Greater responsiveness to the welfare of owners?

To answer these questions is beyond the scope of this introduction. Some intimations of the foregoing analysis may nevertheless be noted to speed the transition. The benchmark of comparison is what would have happened had the companies continued unaffiliated.

Speedier responsiveness to consumers' signals is a potential. Conglomeration makes possible a wider panorama of search for the areas of future growth in demand, a more concerted and systematic effort to forecast future growth in demand, and fewer inhibitions about crossing industry lines to exploit the future. These three traits can make a conglomerate better able to see (or foresee) the signals of consumers. Little fellows can move quicker; they inadvertently do much painful market testing for big rivals gratis. But

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potential profitability has been neglected or subordinated to vanity, or inertia. Impaired morale from this source is good.

the conglomerate can respond to these validated consumer signals massively. How? First, because of its eagerness to buy "growth," *i.e.*, to acquire (and sometimes pay dearly for) a small company in a promising new industry as an expansion base, and second, because of its greater resources and internal mobility of capital.

Responsiveness to changed consumer demands requires contraction on some fronts as well as expansion on others. Conglomeration can achieve speedier disinvestment than the agonizing, dilatory procedures of bankruptcy. Partly this is because economic foresight is more objective than that of a corporation's president whose life work is becoming obsolete. Partly it is because of more prompt and cold-blooded capital rationing. The conglomerate possesses a superior, more efficient mechanism both (1) for milking an obsolescent operation and flowing its cash earnings to investment in more promising divisions and (2) for liquidating a poor performer.

The potential is there for more massive responses to consumers' whims, but will it in fact be attained? That depends on the conglomerate's ability to get a good management and to motivate executives entrepreneurially.

As to the second question, speeded commercialization of a technological breakthrough does sometimes result from conglomeration. In the earlier "shirt-losing" stages, commercial application of new technology is usually done better and faster by myriads of backyard inventors and Route 128-type scientist entrepreneurs than by the bureaucracy of a big corporation's new products division. At a later stage the conglomerate has ability to obtain and marshal resources and specialized skills to exploit large and expanding opportunities on a scale and at a speed that is usually unattainable by a member company standing alone. This can achieve a decisive competitive headstart advantage in market position and economies of scale.[25]

Speeding of the spread of advanced managerial technology and financial controls, profit center decentralization, capital rationing and capital sourcing, is a likely consequence of conglomerization. Some staff functions have a high commonality among diverse divisions and hence benefit from the higher specialization and greater rewards of expertness and modernity.

As to the third question, better allocation of resources is, I think, a likely result. (Better in an economic sense, confined to private costs.) Superior mobility of resources results from speeded cross-industry migration of capital: achieved by a pattern of acquisitions and disposals which will milk (and ultimately shrink, close down or sell off) low profit activities and channel their cash generation (and sales proceeds) into the acquisition and forced growth of activities which are in growing demand and short supply, hence yield super profits of innovation and growth. In addition to this superior deployment of investment within its borders, the con-

25 The importance of internal growth of a conglomerate built upon acquired beachheads is indicated by sales growth of ITT of 12 to 14 percent in 1969 from internal growth alone — over $500 million — predicted by Harold Geneen (as reported in *Electronic News*, March 24, 1969).

glomerate usually has greater access and willingness to raise money outside. Deployment of people is a related and more dubious potential superiority. Conglomerates usually acquire the executives as well as the assets. Versatility aside, deployment of management people internally is usually easier and better informed than is movement of executives across corporate boundaries.

A high proportion of the nation's savings are corporate savings (depreciation plus net profits). And a high proportion of investment (intangible plus tangible) is financed by the corporation's own cash flow. Consequently, although in principle, capital rationing could be done by the security markets, most equity capital has been sourced internally in recent years. Hence the practical choice for our problem lies between doing it inside the small constituent companies or inside the larger conglomerate.

Does conglomerate merger make management more responsive to the interests of stockholders? Conglomerates, like professional managerial revolutionaries, give stockholders who are unhappy about management, an option (other than selling their stock). And greater responsiveness to the long-run welfare of the owners may result from *threat* of take-over. Managers of the individual units of a conglomerate are, moreover, held to stricter accountability for profit, sales and market share performance than is the president of most independent companies. Offsetting this in some degree is the increased personal power of the head of the conglomerate and the propensity of many to expend their energies on acquisitions and to put growth and personal power ahead of the long-run welfare of the owners. Thus, the degree to which conglomeration increases responsiveness to the welfare of owners is extremely sensitive to the competence and the motivation of the chief executive and his ability to develop, keep, and motivate managers of the constituent companies in the absence of being able to give them the two strongest motives of an enterprise system: ownership and independence. Offsetting these are three unfavorable potentials for the common stockholder. First, he frequently pays what in retrospect looked like a high price for the acquisitions. Even though it was traded out in high-multiple Chinese dollars, the cost in preferred dividend remains after the convertibility bubble has burst. Second, he is saddled with heavier fixed charges of preferred dividends and usually pays higher corporate income taxes than would have been the optimum tradeoff for postponing the seller's capital gains taxes; thus he pays a stiff price for the magic of a "tax free" deal which makes acquisitions easier for the corporate conquistadors. Third, he endures substantial and vaguely known dilution of his long-run future welfare by convertibles and warrants.